No. 12079

In the United States Court of Appeals for the Ninth Circuit

Wilshire & Western Sandwiches, Inc., a Corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum opinion of the Tax Court (R. 27-40) is not reported.

JURISDICTION

The petition for review (R. 42-46) involves federal income taxes for the years 1942 and 1943 and declared value excess profits taxes for the year 1943. On January 31, 1946, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency in the total amount of $3,347.95. (R. 8-9.) Within ninety days thereafter and on April 24, 1946, the taxpayer filed a petition for a redetermination of that deficiency with the Tax Court under the provisions of Section 272 of the Internal Revenue Code. (R. 4-22.) The decision

of the Tax Court sustaining the deficiency was entered on June 29, 1948. (R. 41.) The case is brought to this Court by a petition for review filed September 20, 1948 (R. 47), pursuant to Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Did the Tax Court correctly determine that advances made to the taxpayer by its incorporators did not create an "indebtedness" within the meaning of Section 23 (b) but were contributions to taxpayer's capital, and that purported "interest" payments were not deductible?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
>
> (26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> Sec. 29.23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *
>
> * * * * *
>
> Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in

the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, section 121 and section 29.22 (a)-17.) * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

Sec. 35.719-1. *Borrowed Invested Capital.*—* * *

* * * * *

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

STATEMENT

The facts as found by the Tax Court are as follows (R. 27-35):

The taxpayer was incorporated on March 24, 1941, under the laws of California, with an authorized capital

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STATEMENT

The facts as found by the Tax Court are as follows (R. 27-35):

The taxpayer was incorporated on March 24, 1941, under the laws of California, with an authorized capital

stock of 7,500 shares of common stock, par value $10 each, for the purpose of engaging in the drive-in restaurant business. The incorporators of taxpayer were M. A. McDonnell, William H. Simon, Mike Lyman, and Harry B. Carpenter. (R. 27.) Its articles of incorporation empowered taxpayer, among other things, to borrow money and issue its notes therefor. (R. 27-28.) It kept its books and prepared its returns on the accrual basis. It filed its returns for the taxable years with the Collector for the Sixth District of California. (R. 28.)

Discussions resulting in the formation of taxpayer started the early part of 1941. The original plan was to operate a combination drive-in and restaurant and cocktail room at Wilshire and Western Avenues, as a substitute for an old drive-in restaurant then being operated by Carpenter a block away. A lease was negotiated under the terms of which the lessor was to erect suitable improvements at a cost of about $75,000. Carpenter did not desire to operate a combination restaurant on account of its size. In the meantime, Simon, acting for himself, negotiated a lease for another corner of Wilshire and Western Avenues for the purpose of operating a drive-in restaurant. Thereafter, but before taxpayer was incorporated, the interested parties abandoned the plan under consideration and decided to construct a drive-in restaurant on the lot covered by the lease negotiated by Simon. (R. 28.)

About April 1941, taxpayer's incorporators discussed for the first time the question of financing the construction of the restaurant out of advances by them to taxpayer for the purchase of its stock and as loans. The original intention was to make advances totaling $30,000 for stock and loans on an equal basis. (R. 28.) The individuals desired to be in a position to participate with general creditors for part of their investment in the event taxpayer's business was not successful. (R. 28-29.) In addition, they regarded a loan to be a better

investment than stock to obtain returns on and repayment of their capital outlay. The individuals discussed the question of borrowing money from a bank and decided that they would rather receive the interest than to have taxpayer pay it to a bank. They also discussed the tax benefit that would accrue to them and taxpayer under the plan. Simon, who with his brother Mike Lyman was regarded as a unit in the transaction, considered his contemplated loan to be a safe investment. The same individuals, or some of them, entered into similar transactions for the same reasons with nine other corporations, one each in 1937 and 1939, six in 1941, and one in 1942. In all except two of the transactions, the notes received for loans were in proportion to the stock received. (R. 29.)

Simon negotiated for, and on April 26, 1941, entered into, a lease for a corner lot at Wilshire Boulevard and Western Avenue, Los Angeles, for a period of fifteen years. The lease provided for the improvement of the premises by a drive-in restaurant building at a cost of not less than $30,000. The lease was acquired by Simon with the understanding that he would assign it to taxpayer, and was assigned by him to taxpayer in July, 1941. The understanding was that Carpenter would supervise the construction of the building and operate the business. (R. 29.) Three of the four individuals estimated that the improvements, including equipment, would cost about $30,000. Carpenter, the other individual, first believed that the cost would be about $50,000, and in July 1941, concluded that the cost would be $38,000 or $39,000. (R. 29-30.) Simon and Carpenter estimated that the cost of the equipment would about equal the cost of the building. (R. 30.)

About June 15, 1941, bids were solicited for the construction of the building on the leased premises, and on July 10, 1941, a contract was entered into for the construction of a building at a cost of $22,651. The con-

struction work was substantially completed about October 25, 1941, and the restaurant was opened for business about November 5, 1941. (R. 30.)

The incorporators of taxpayer made the following payments, totaling $55,000, to taxpayer in 1941 under the plan previously adopted by them (R. 30):

	McDonnell	Simon	Lyman	Carpenter
May	$3,333.33	$.......	$.......	$.......
June	....	1,666.67	1,666.66	3,333.34
August	....	2,500.00	2,500.00	....
September	5,000.00	....	....	5,000.00
October	....	2,500.00	2,500.00	....
Nov. 13	....	2,500.00	2,500.00	....
Nov. 19	10,000.00	....	....	5,000.00

The payments made on November 13th and 19th were agreed upon at an informal meeting held on November 12. At the same meeting the parties reached an agreement on the division of the advances between stock and notes. At the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof, and notes for the remainder. No receipts were given by taxpayer for the advances. (R. 30.)

The money was first used to pay for the cost of preparing plans and specifications for the building, and thereafter for the construction of the building and the equipment installed therein. (R. 30-31.) The amount of $38,114.68 was spent in 1941 for the building and $17,515.78 for equipment, a total of $55,630.46. In January 1942, the additional amount of $2,375 was spent for building costs and, in that and the next month the additional amount of $7,787.26 was spent for equipment. An expenditure of $55,000 was necessary to place the restaurant in condition to open for business. (R. 31.)

About February 1, 1942, taxpayer borrowed $10,000 from its stockholders to pay bills outstanding for the construction of the building and equipment of the

restaurant. Carpenter and McDonnell each loaned one-third of the amount and Simon and Lyman each a one-sixth. Carpenter did not advise the other stockholders of the need for the money until a short time before the loans were made. The loans were paid on September 7, 1942, without interest. (R. 31.)

About July 14, 1941, taxpayer, pursuant to a resolution adopted by its board of directors on that day, filed an application with the Department of Investment of the State of California for permission to issue 1,500 shares of its stock for cash to its incorporators, and G. C. Jobson, and the remainder of its stock when authorized by its board of directors. (R. 31.) The application recited that taxpayer proposed to borrow from the stockholders or incorporators an additional amount sufficient to complete the building and equip it for the operation of a restaurant. (R. 31-32.) At the same meeting, Carpenter was elected president and Simon vice president of taxpayer. On July 17, 1941, the Commissioner of Corporations authorized taxpayer to sell to the individuals named in its application for cash, at par, not to exceed 7,500 shares of its stock. (R. 32.)

At a meeting of the board of directors of taxpayer, the membership of which included the four incorporators, on November 13, 1941, a resolution was adopted, in accordance with an agreement reached at an informal meeting the previous day, to issue to the incorporators for advances made by them promissory notes, totaling $25,000, maturing in two years with interest at the rate of 6 percent per annum, payable quarterly, and stock, totaling $30,000, as follows (R. 32):

	Carpenter	McDonnell	Simon	Lyman
Stock	$10,000.00	$10,000.00	$5,000.00	$5,000.00
Notes	8,333.34	8,333.33	4,166.67	4,166.66

The stock and notes authorized by the resolution were issued under date of November 13, 1941, and were de-

livered by December 5, 1941. In case of default in the payment of interest, the notes were to be immediately due and payable at the option of the holder. On November 25, 1941, 50 shares each of the stock issued to Simon and Lyman were transferred to Joseph Lardemar, in accordance with a gift made of the stock prior to November 13, 1941. (R. 32.)

Carpenter expected the notes to be paid if taxpayer had funds for that purpose. (R. 32.) Simon expected the notes to be paid out of current earnings and would not have insisted upon payment if payment would have caused financial hardship to taxpayer. (R. 32-33.)

Amounts, totaling $3,055.86, were paid to the noteholders on December 1943, as interest on the notes to November 30, 1943. Like payments, aggregating $682.10, were paid on March 23, 1945. The amounts were entered on the books of taxpayer as a charge to an account under the name of "Interest Payable Accrued," which account was opened in February or March 1943, as of the close of 1942, with a credit to the account as interest accrued on the notes to December 31, 1942. The face amount of the notes was paid in full by payments of $10,000 each, on April 21, 1943, and May 23, 1944, and $5,000 on March 23, 1945. The payment to the holder of each note was in proportion to his holdings of all of the notes. (R. 33.)

In October, 1941, Carpenter requested a certified public accountant to outline a set of books for taxpayer's bookkeeper to install and use. After receiving the minutes of taxpayer, the accountant prepared a list of entries. The journal entry showed that taxpayer was incorporated with a capital of $75,000, consisting of 7,500 shares of a par value of $10 each. The outline of accounts to be used included an account for notes payable. Carpenter did not inform the accountant that part of the advances made by the incorporators was to be treated as loans to the corporation. (R. 33.)

Taxpayer's account under the name of "Capital Stock Unissued" contained a charge of $75,000 and a credit of $55,000 on December 31, 1941. Its account "Stock Subscriptions Receivable" contained at that time a charge of $55,000 and a credit for the same amount. (R. 33-34.) The books also showed capital stock of $75,000, of which $55,000 was set aside against an account under the name of "Cash Special $55,000." The books did not, on December 31, 1941, reflect any notes payable to stockholders. Sometime between January 15 and March 7, in 1942, the accountant took a trial balance from taxpayer's books for the purpose of preparing taxpayer's income tax returns for 1941. The balance sheet included in the income and declared value excess profits tax return listed as an asset capital stock subscriptions in the amount of $55,000 and as a liability a like amount for capital stock. The return was signed by Carpenter, as president, and H. B. Carpenter, Jr., as treasurer, without objection to the return as prepared by the accountant or reading the return. Taxpayer's president was aware that the affidavit he signed contained a statement that the return was correct. (R. 34.)

In April or May, 1942, taxpayer employed another accountant to examine its books. The accountant had knowledge that the stockholders of taxpayer held notes of the corporation. He ascertained from a trial balance taken as of December 31, 1941, that the books did not reflect the notes issued to the stockholders under the date of November 13, 1941, and erroneously reflected the capital stock outstanding. (R. 34.) After discussing the matter with Carpenter and Simon, the accountant made entries in the books to reflect notes outstanding of $25,000 and capital stock outstanding of $30,000. (R. 34-35.) While the accountant was preparing taxpayer's income tax return for 1942, he ascertained that no amount had been accrued for interest on the notes. An appropriate account was then opened and the amount

of $1,687.50 was entered therein as interest accrued on the notes to the close of 1942. Thereafter interest was accrued on the notes monthly. (R. 35.)

The earned surplus account of taxpayer discloses credit balances of $2,468.16, $9,740.40, $17,980.01, $45,752.61, $51,349.06, and $59,289.40 at the close of the years 1941 to 1946, inclusive. The account contains no charge for dividends. (R. 35.)

Taxpayer's president, who testified at the hearing, was at an undisclosed time indicted in a Federal District Court in California for filing false and fraudulent individual returns and like returns for a firm doing business under the name of Carpenter's Drive-In. At the trial, Carpenter entered a plea of *nolo contendere* and paid a fine, imposed by the court. No sentence of imprisonment was imposed by the court. (R. 35.)

In its returns for 1942 and 1943 the taxpayer claimed $1,500 and $1,443.26, respectively, as deductions for interest on the notes held by its stockholders. In his determination of the deficiencies the Commissioner held that the amounts were not deductible under Section 23 (b) of the Internal Revenue Code. (R. 35.)

The Tax Court found also in its opinion as follows:

> The general plan was decided upon prior to any business activity of taxpayer and was intended to meet capital outlays which are usually paid out of invested capital and/or secured indebtedness. Similar arrangements were made by the stockholders, or some of them, in connection with other corporations formed to engage in the restaurant business. (R. 36.) No evidence was offered to establish that the individuals were lenders of money other than under plans such as the one here under consideration. (R. 36-37.)
>
> The advances here have few of the usual characteristics of commercial loans entered into in arm's length transactions. All of the amounts were paid in to pro-

vide taxpayer with funds to start business, hence all of it was working capital. The original plan was to take stock and notes on an equal basis and three of the four interested parties estimated that an expenditure of about $30,000 would be sufficient to open the restaurant for business. The amount of $55,000 was required to place the restaurant in condition to commence business, yet there was no agreement to advance the final $30,000 paid in until November 12, 1941, which was a week after the restaurant was opened for business, and until then no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans. The plan finally adopted and made effective on the division of the advances between stock and notes was not in accordance with the agreement originally entered into, which discloses that the parties were at all times in a position to divide the advances between stock and notes in any proportion. The portion regarded as a loan by each stockholder was in direct proportion to his holding of stock. (R. 37.)

Some of the funds were advanced as early as May 1941, yet no interest thereon was incurred by taxpayer prior to November 13, 1941. In the meantime, there was no agreement on when interest would start, the rate of interest, or an agreement with taxpayer on when the loans would mature, contrary to the manner loans are generally made. (R. 38.)

The notes were not entered in the books until April or May 1942, and although interest was payable quarterly, none was accrued on the books until 1943 and no interest was paid until December 1, 1943, or more than two years after the notes were executed. The terms of the instruments gave to the holders thereof the right to declare the principal and interest immediately due and payable upon default in the payment of interest when due. No evidence was offered that any of the note holders exer-

cised the right. The final payment on the notes was not made until March 23, 1945, or more than sixteen months after maturity, and the payment made each time to each was in direct proportion to his holdings of all of the notes. No evidence was offered to show any demand for payment at maturity. (R. 38.)

The intent of the parties with respect to a part of the advances as bona fide loans, is reflected in testimony of Simon, who, with his brother, was regarded as a unit in the transaction, and Carpenter. The former testified that he expected the note to be paid at maturity, but would not have insisted upon payment if payment would result in financial hardship to taxpayer. The latter did not expect payment unless taxpayer had funds. It is apparent from the testimony that they did not intend to assert rights of a bona fide lender; instead regarded the amounts as being subject to the risks of the business and looked to repayment out of corporate earnings. (R. 39.)

The taxpayer had earned surplus of about $51,000 by the close of 1945, or double the amount of its outstanding stock, yet paid no dividends on its stock during that period, which strongly indicates that the stockholders looked to the notes for income on their investments and a partial return of capital. (R. 39.)

SUMMARY OF ARGUMENT

The single issue presented is whether certain payments made by taxpayer to its incorporators constituted "interest" on "indebtedness" and were deductible under Section 23 (b) of the Internal Revenue Code. Prior to the legislative rejection of the *Dobson* rule, appellate review of such questions was foreclosed. Contrary to taxpayer's contention however, the statutory change in the scope of this Court's reviewing powers does not grant taxpayer a *de novo* consideration of the evidence and issues, for the function of weighing evidence, drawing inferences, and choosing between

conflicting inferences is that of the Tax Court. The essential problem is whether a bona fide creditor relationship existed or, stated differently, whether the security holders actually intended to assert the rights of creditors. The precise boundaries of this Court's reviewing power are not significant in this case since the evidence overwhelmingly supports the determination of the Tax Court that a bona fide creditor relationship was not established but rather that the advances were contributions to taxpayer's capital. The incorporators, having received notes in direct proportion to their stock holdings in a closely held corporation, were in a position to convert a portion of their original capital investment to the form of indebtedness while retaining the same relative control and interest in the management, the assets and earnings of the taxpayer. Even after the advances were made to the taxpayer, the incorporators were in a position to formally divide their investment between notes and stock in such proportions as they desired. When the sums were advanced no maturity date was fixed, no interest rate was established and the amount of indebtedness was itself not fixed. The books of the taxpayer treated the entire advancement as capital. No "interest" was accrued on the books until almost two years after the purported "loans" and no "interest" was paid or apparently demanded until 1943, despite the fact that the notes issued in 1941 called for quarterly payments of "interest". The notes were not paid until sixteen months after the recited maturity date and the record does not show that any prior demand for payment was made. The interest and notes were paid out of earnings and constituted the only distributions of corporate earnings to the stockholders though ample funds were available. The testimony of the incorporators indicates that they did not intend to assert the rights of creditors unless the fortunes of the corporation so warranted.

ARGUMENT

The Tax Court Properly Determined That Advances Made to Taxpayer by Its Incorporators Were Contributions to Taxpayer's Capital and That Purported "Interest" Payments Were Not Deductible under Section 23 (b)

The single issue here presented is whether taxpayer has clearly established a right to deduct certain corporate payments as "interest" on "indebtedness" under Section 23 (b) of the Internal Revenue Code, *supra* (*White* v. *United States,* 305 U.S. 281, 292; *Deputy* v. *du Pont,* 308 U. S. 488, 493); or whether on the contrary the Tax Court was justified in holding that the alleged indebtedness was in reality a contribution to taxpayer's capital. The Commissioner is of course aware of the statutory change in this Court's scope of review of such questions and of the legislative rejection of the rule in *Dobson* v. *Commissioner,* 320 U. S. 489, discussed at some length by taxpayer. (Br. 43-47.) However the rejection of the *Dobson* rule which precluded appellate review of Tax Court determinations on such questions as that now presented (*John Kelley Co.* v. *Commissioner,* 326 U. S. 521), does not entitle the taxpayer to a *de novo* consideration of the case, which is the essence of taxpayer's contention. Long prior to the emergence of the *Dobson* rule it was firmly established that it was the province of the Tax Court "To draw inferences, to weigh the evidence and to declare the result * * *". *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 294; *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40. Equally well established was the Tax Court's power to "choose between conflicting inferences". *Wilmington Co.* v. *Helvering,* 316 U. S. 164, 168. At any rate, such questions as to whether taxpayer's incorporators genuinely intended to occupy the status and assert the rights of creditors, and whether they intended that the purported "interest" payments be dependent upon the fortunes of the business are questions of pure fact; and

the Tax Court's determination in such respects may be disturbed only if clearly erroneous. Rule 52, Rules of Civil Procedure; Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess. Taxpayer's position is all the more extraordinary in view of the fact that taxpayer's affirmative case was almost entirely dependent upon the oral testimony of self-interested witnesses whose credibility was very much in issue and whose testimony, in the light of the actual course of events, was manifestly subject to conflicting inferences.

At the outset it is appropriate to consider the circumstances under which the orginal advances to the corporation were made. Where, as here, the total working capital of a closely held corporation is advanced by the incorporators who received not only stock but also "promissory notes" in direct proportion to their stock holdings, the transaction must be subjected to close scrutiny by the Commissioner and the courts. *Janeway* v. *Commissioner,* 2 T. C. 197, affirmed, 147 F. 2d 602 (C. A. 2d). In each case the fundamental question is whether a creditor or a stockholder relationship exists; and where the incorporators receive both stock and "notes" in direct proportion to their respective investments, they are in a position to convert what is in essence a portion of their capital contribution to the form of indebtedness while retaining the same relative control and interest in the management and in the assets and earnings of the corporation. They are, in short, in a position to formally classify as interest payments sums of money to which they would be entitled as stockholders in the form of dividends. The Tax Court did not, as taxpayer suggests (Br. 21), lay down a rule of law that stockholders may not also be creditors of a corporation, nor did the Tax Court indicate that the fact that the notes and stocks were proportionate

to the relative investments was determinative. The Tax Court was however entitled to consider the circumstance in view of the oft repeated and fundamental principle that in the field of taxation the primary concern is with substance and reality and not with form. *Helvering* v. *Lazarus & Co.,* 308 U. S. 252; *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44. In considering the circumstances surrounding the original investment it is interesting to note that not until after a substantial portion of the money invested was advanced to the corporation, was it determined how much should represent indebtedness and how much capital contribution. (R. 37.) Apparently it was originally agreed that the investment would be "split * * * up on a fifty-fifty basis, half in the form of loans, half in the form of capital contribution". (R. 28, 120.) Mr. Carpenter, taxpayer's president, testified that the incorporators "couldn't determine the amount to be issued in stock or the amount to be issued in notes" (R. 125); and, as the Tax Court found (R. 37), the plan finally adopted as to the division between stocks and notes was not in accordance with the original plan. The taxpayer in its brief (p. 35) explains the variance as being the consequence of an "agreement by the individuals to waive a small portion of their loans and to accept stock in lieu thereof". As the Tax Court noted (R. 37), this would indicate that the incorporators were at all times in a position to divide the advances between the stock and notes in whatever proportions they deemed advisable; and this would hardly indicate the existence of a bona fide creditor relationship. On the contrary, it seems manifest that the ultimate division between stock and "notes" was formalistic and without substance. Moreover, it is apparent that the incorporators were committed among themselves to advance the necessary capital in one form or

another; and when this be considered in connection with the additional fact (R. 37) that the entire $55,000 advanced was necessary to place the restaurant in condition to commence business, it is reasonable to conclude that the entire funds supplied by the incorporators were subject to the hazards of the business and part of its capital structure. See *Green Bay & W. R. Co.* v. *Commissioner,* 147 F. 2d 585, 587 (C. A. 7th). The fact that no receipts were given the incorporators, that no interest was ever paid or accrued even belatedly for the period between the time the funds were advanced in May 1941 and November 1941, and the fact that the maturity date, the rate of interest and indeed the amount of "indebtedness" itself were not fixed when the purported "loans" were made (R. 38), cast substantial doubt on the existence of a bona fide creditor relationship.

When the overwhelming evidence in support of the Tax Court's determination is considered, in addition to the aforementioned circumstances surrounding the original investment, it is manifest that inquiry into the precise limits of this Court's review is not material in this case. Apart from the testimony of the incorporators to the effect that they intended that part of their investment to be taken in the form of loans, and the fact that "promissory notes" were issued, there is little in the record to support the contention that a bona fide creditor relationship existed. That the nomenclature given a security is not conclusive has long been established. *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C.A. 2d). It is significant that taxpayer's own books did not reflect any promissory notes or indebtedness to the taxpayer's incorporators. On the contrary the entire $55,000 was originally listed as "Stock Subscriptions Receivable." The books showed a total capital stock of $75,000 and no corporate indebt-

edness to the stockholders. Moreover some time prior to March 7, 1942, taxpayer's accountant took a trial balance from taxpayer's books for the purpose of preparing taxpayer's income tax return, and the balance sheets included in the income and declared value excess profits tax return listed as an asset capital stock in the amount of $55,000. This return was signed by taxpayer's president. (R. 34, 102-104; Joint Ex. 8H.) Sometime subsequently a line was drawn through the 55 on taxpayer's books and this was changed to 30. A corresponding "note account" was then set up. (R. 160, 210.) No satisfactory explanation was offered as to the listing of the entire $55,000 as a capital stock subscription. The initials of taxpayer's bookkeeper were entered in the books. (R. 178.) No error on the part of the bookkeeper or the accountant, Mr. Whittaker, was proved. If an error existed it seems clear that it was in the form and not in the substance of the corporate structure.

Still more important is the fact that although the "promissory notes" issued in 1941 provided for quarterly payments of "interest", no interest was even accrued on taxpayer's books until February or March 1943, and the first entry was dated back to December 31, 1942. (R. 214.) Moreover no "interest" was in fact paid until November or December 1943, nor is there any evidence that prior demand for an "interest" payment was ever made. (R. 38, 215.) When taxpayer's president was asked why no prior "interest" payments were made he replied "carelessness". (R. 141.) It is submitted that although such a reason might possibly have satisfied the corporation's stockholders, it would not have been satisfactory to a bona fide creditor. One of the fundamental characteristics of a creditor is the right to receive interest regardless of the fortunes of the business. *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C.A. 7th).

Another of the essential attributes of a creditor's obligation is a fixed date for the payment of the obligation. *Haffenreffer Brewing Co.* v. *Commissioner,* 116 F. 2d 465 (C.A. 1st), certiorari denied, 313 U. S. 567; *Commissioner* v. *O. P. P. Holding Corp.,* 76 F. 2d 11 (C.A. 2d). On the other hand the mere recitation of a maturity date in a security, especially where issued by a closely held corporation to its stockholders does not establish the fact that the parties actually intended payment of "a definite sum at a fixed time". *Commissioner* v. *O. P. P. Holding Corp., supra,* p. 12. In the instant case the final payment of the notes was not made until May 23, 1945, or more than sixteen months after the maturity date recited in the notes. (R. 38, 139.) There is no evidence in the record to indicate that timely payment of the principal was ever demanded or that the holders of the "notes" had ever exercised the right given of declaring the principal and interest immediately due and payable upon default of the interest. (R. 38.) Again it is submitted that if the relationship was actually one of creditor and debtor, the creditors would not have been so lax in enforcing their rights and protecting their investment. The only reasonable conclusion to be drawn from the conduct of the parties is that it was never intended to assert the right to demand from the corporation a fixed amount on a fixed date in payment of the obligation, but rather that it was intended to recover this portion of the capital investment when and if the fortunes of the business warranted. It is interesting to note the observation of the Tax Court (R. 38-39) that an additional $10,000 borrowed from the stockholders in 1942 was repaid the same year, or fifteen months prior to the first "interest" payment on the "notes" (R. 196). This variance in treatment would seem to highlight the distinction between the original advances evidenced by the "notes" and actually a part

of the necessary capital of the corporation, and the subsequent loan to the corporation by its stockholders to meet the temporary needs of the business. Moreover, as the lower court observed (R. 39), since no additional capital came into the business, the "notes" and the "interest" were in fact paid out of the revenue of the business. Since the taxpayer admittedly had an earned surplus of $51,000 by the close of 1945, which was double the amount of its outstanding stock and yet paid no dividends on its stock during that period (R. 39), the Tax Court was justified in inferring that the stockholders looked to the notes for income on their investments and a partial return of capital.

As stated in *Commissioner* v. *Meridian & Thirteenth R. Co., supra,* p. 186, "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event". The Tax Court concluded here that the incorporators did not intend to assert the rights of bona fide creditors, that the advances were intended to be subject to the risks of the business and that the incorporators expected to be repaid in full for the monies advanced in the form of loans only if the taxpayer had sufficient earnings to make the payments without financial hardship. (R. 39, 46.) The conclusions are supported not only by the previously discussed evidence but by the testimony of the incorporators. William Simon admitted on cross examination that he would not have insisted upon payment if it meant a financial hardship to the business. (R. 90.) Mr. Carpenter's testimony (R. 149-150) was at least subject to the inference that he expected the "notes" to be repaid only if taxpayer had funds available (R. 32). It is not surprising that the witnesses did not straightforwardly testify that they expected to be paid only out of earnings and

profits; for as a practical matter it must be recognized that the testimony was subject to the possibility of being colored by self-interest; and it was for the trial court to choose between the conflicting inferences. Taxpayer's suggestion (Br. 14) that the oral testimony of Simon was the only evidence before the Tax Court on the question of intent is not understandable in view of the overwhelming evidence previously discussed here and carefully considered by the Tax Court as bearing on the question of whether a creditor or a stockholder relationship existed in connection with the "notes". In seeking to explain the testimony of Simon to the effect that he did not intend to press his claim for the funds purportedly "loaned" if it meant financial hardship to the corporation, taxpayer suggests (Br. 39) that this is not extraordinary in view of Simon's proprietary interest. This position can hardly aid the taxpayer's case. It is the contention of the Commissioner that in advancing the sums involved to the corporation, the incorporators intended to act and did act as proprietors and not as creditors. Apparently it is taxpayer's position that the holders of the "notes" may treat themselves as creditors for taxation purposes but conduct themselves as stockholders in regard to the alleged "loans".

Nor is taxpayer's attack on the Tax Court's findings and conclusion at all justified. A reading of the formal findings of fact and the opinion suffices to demonstrate that the Tax Court gave careful consideration to all the evidence which bore on the real nature of the relationship between the incorporators and the taxpayer, and that the lower court thoroughly understood the applicable legal principles and correctly applied them. Taxpayer apparently assumes that there are a few fixed criteria beyond which the Tax Court may not look in determining whether the purported creditor relation-

ship was in substance a stockholder relationship. Moreover, taxpayer completely distorts the lower court's findings and opinion by segregating and independently considering each sentence of the findings and opinion out of context. The lack of merit in taxpayer's appeal becomes patent when the Court considers the fact that the stockholders received "notes" in direct proportion to their stockholdings; that they were apparently in a position to formally divide up their investment between stock and notes in whatever proportions they desired even after the sums were advanced; that when the sums were advanced no maturity date was fixed, no interest rate was established, and indeed the amount of indebtedness was not fixed; that the books of the corporation treated the entire advancement as capital; that no interest was accrued on the books until almost two years after the alleged "loans"; that no interest was paid or apparently demanded until 1943, despite the fact that the notes issued in 1941 called for quarterly payments; that the notes were not in fact paid until sixteen months after the recited maturity date, nor was any prior demand apparently made; that the interest and notes were in fact paid out of earnings and constituted the only distribution of corporate earnings to the stockholders though ample funds were available; and that the holders of the notes obviously did not intend to demand payment unless the fortunes of the corporation warranted.

Taxpayer's contention that the Tax Court's findings do not support its conclusion can be rationalized only by giving to the findings referred to a meaning obviously not intended by the lower court, and by considering the specific findings out of context. When the Tax Court, in reciting the facts, stated that it was originally intended to make advances for stock and loans on an equal basis, and that it was intended that stock be issued for half and notes be issued for the remainder, the Tax Court stated what is conceded by all, namely, that the

incorporators intended to take half their investment in the form of notes and half in the form of stock. These findings certainly did not signify that a bona fide creditor-debtor relationship was established or intended. Indeed the Tax Court specifically found to the contrary. (R. 39.)

CONCLUSION

The decision of the Tax Court is patently justified and indeed required by the facts and the law and should be sustained.

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